# Media Comment
## For immediate release

South African Institute of Race Relations
*The power of ideas*

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**Budget analysis 2016**

**SA economic outlook 2016: finance minister undershoots, stagflation the likely outcome**

*Despite South Africa's finance minister, Pravin Gordhan, saying in his budget speech this afternoon that South Africa is "imaginative and resilient enough" to turn the economy around and that "we need action and not just words", the steps announced in his speech did not go nearly far enough to halt and reverse South Africa's economic decline. In this analysis IRR Chief Economist, Ian Cruickshanks, provides a sobering reality check of what to expect from the economy in 2016.*

The collapse of global investor confidence in South Africa's political leadership has translated into plunging domestic and business confidence, leading to a sharp decline in all areas of domestic economic activity. This is likely to remain the case throughout 2016.

Global economic activity has declined as China, previously seen as the world's primary growth engine, attempts to switch from an industrial export-based economy to a growing domestic consumer demand model. This has contributed to lower demand for energy and base industrial commodities, severely limiting South Africa's export prospects. Plunging commodity prices have added downside momentum as producers battle to maintain revenue to offset hefty long-term infrastructural developments, through holding production levels at record highs. This is most dramatically confirmed by the current spot price of Brent Crude oil at $31/barrel after peaking at $130/barrel in 2012. For South Africa low commodity prices have been exacerbated by falling risk appetites amongst global asset managers.

Declining momentum in recovery from the 2008/2009 global financial markets recession has also negatively impacted growth in the European Union and the United States, further limiting South Africa's export potential.

The near perfect economic storm has drawn further strength from the severe drought that has resulted in crop failures, necessitating imports at high global market prices pushing up domestic food inflation, adding further strain to trade and current account deficits, and worsening already high producer and consumer inflation underpinning the overall consumer price index.

A rapid fall in business activity has led to widespread job losses pushing up the "real" unemployment rate to around 36%. Amongst the youth unemployment is estimated to be over 60%. This "lost generation" are increasingly impulsive in expressing their frustration with their inability to find jobs and improve their own standards of living. This has in turn been a key contributor to rising levels of often violent protest action in the country.

Foreign investors have watched these developments closely and responded in slowing foreign capital inflows and - in 2016 – triggering a net capital outflow for the year-to-date. Foreign direct investment associated with fixed capital developments has dwindled towards zero. This has undermined business confidence, further constraining South Africa's growth prospects, limiting new business development, promoting job destruction and putting the brakes on consumer spending. Household consumer expenditure accounts for around 65% of total GDP and an index of current and future expectations for consumer financial activity has deteriorated rapidly. The current depressed consumer mood will certainly have a restraining impact on GDP and on medium term growth prospects.

The Reserve Bank's 50 basis points hike in interest rates in January will add to the burden on the business and consumer sectors, already weighed down by higher electricity tariffs and other administered service tariffs. The proposed tax increases – direct and indirect - announced in the 2016 budget will further curb any potential exuberance in consumer activity. There is no way to tax an economy out of a low growth and low investment trap.

The hawkish stance of the Reserve Bank's Monetary Policy Committee could lead to further rate hikes if inflation rises further ahead of their expectations. Domestic inflation is likely to rise to a peak in the current cycle above 7%, well in excess of government's guideline range of 3-6%. This will ensure the continuation of tight monetary policy, raising the cost of new business start-ups and again slowing business and consumer credit demand.

Meanwhile, the trade account deficit will rise due to the increased cost of imports, primarily oil and food, while export proceeds languish under the threat of diminishing global demand. Financing the rising twin deficits (current account and budget) will become increasingly difficult due to a declining offset from current foreign portfolio outflows.

These factors and any other developments likely negatively impacting South Africa's economic stability/instability will be carefully observed by the international credit rating agencies. This underlines the importance of a tight rein being kept on government expenditure, particularly in keeping wage awards below the inflation target. But more than fiscal prudence, ratings agencies will need to be convinced that there is a compelling case for growth. In failing to make that case a ratings downgrade is now likely for South Africa.

Further ratings downgrades, even if accompanied by the majority of the emerging markets sector, will result in South African securities being classified as non-investment grade (junk) status. Access to foreign capital could become considerably more costly and difficult to source. The likely ripple impact through to the currency would undoubtedly push inflation higher on rapidly escalating import costs.

The risk is that the rising number of unemployed people will demand higher social grants, even further curtailing government's long delayed infrastructural development plans, and likely leading to even lower overall economic activity. Under these increasingly likely circumstances we expect a 0.0% (zero %) change in GDP in 2016, with the possibility of downside potential with a shrinking economy and high inflation – in other words 'stagflation'. In this respect our forecasts are well below those of the minister and we would caution that his deficit targets therefore seem improbable.

It will take considerable micro-policy reforms (in areas of labour, empowerment, property rights, and education policy), far beyond what was announced by the minister today, to put the South African economy back in a position to reach even modest rates of economic growth let alone rates that would allow any significant growth in job creation. It is of great concern that there was no mention of how the government intends to address the real constraints to investment that companies and investors routinely identify to the IRR. It is not enough to simply repeat that there is a commitment to 'inclusive growth', that 'we must continue working together' and that 'investment growth must be scaled up' – investors are looking to how the government intends to achieve this. Tax hikes and austerity measures will simply not suffice and may indeed extend South Africa's stay in the economic doldrums if a compelling strategy for growth is not implemented.

- *The IRR is a think-tank that promotes political and economic freedom.*

**Ends.**